[JOINT COMMITTEE PRINT]

OVERVIEW OF TAX RULES APPLICABLE TO EXEMPT ORGANIZATIONS ENGAGED IN TELEVISION MINISTRIES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON OCTOBER 6, 1987

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on October 6, 1987, on the Federal tax rules applicable to tax-exempt organizations engaged in television ministries.

In its press release on the hearing dated September 14, 1987, the Subcommittee stated that it "intends to consider the Internal Revenue Service's administration and enforcement of present Federal tax law, and television ministries' interpretation of, and compliance with, these rules." The release also states that "the Subcommittee is not undertaking to investigate any specific television ministry or tax-exempt organization," and is "not questioning religious practices or beliefs." Further, the release notes, "Constitutional issues involved in the Federal tax laws that the Subcommittee will be reviewing have been addressed by the courts." Accordingly, the release states that "the Subcommittee will not consider any such matters at the hearing, but rather, will focus on the operation of present-law rules."

This pamphlet,[1] prepared in connection with the hearing, contains an overview of tax rules applicable to exempt organizations engaged in television ministries. The tax rules described in this pamphlet, which generally apply to churches or other religious organizations (whether or not engaged in broadcast ministries), relate to (a) the tax status of churches and other religious organizations (including rules relating to filing an exemption application and information returns), (b) the prohibition on inurement of net earnings of a tax-exempt religious or charitable organization to private interests, (c) restrictions on the political and lobbying activities of charitable organizations, (d) application of the unrelated business income tax to religious organizations, (e) the tax treatment of transfers to charities in exchange for goods or services, and (f) restrictions on IRS audits of churches.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Overview of Tax Rules Applicable to Exempt Organizations Engaged in Television Ministries* (JCS-21-87), October 5, 1987.

OVERVIEW OF TAX RULES APPLICABLE TO EXEMPT ORGANIZATIONS ENGAGED IN TELEVISION MINISTRIES

A. Tax Status of Churches and Other Religious Organizations

General rules

An organization that is formed and operated exclusively for religious purposes qualifies for exemption from Federal income tax, and is eligible to receive tax-deductible contributions, provided that no part of its net earnings inures to the benefit of any private individual and that the organization does not violate applicable restrictions on lobbying activities and prohibitions on political campaign activities (secs. 501(c)(3) and 170). For example, a nonprofit religious broadcasting station may qualify for tax-exempt status under section 501(c)(3) where the station broadcasts worship services conducted by ministers, religious guidance, and inspirational music, and does not devote more than an insubstantial amount of broadcast time to commercially sponsored nonreligious programs.[2]

More favorable tax rules apply in the case of churches than in the case of other types of religious organizations. Churches are not required to file an exemption application with the IRS, or to receive a determination of tax-exempt status from the IRS, as a condition of exemption from income tax or eligibility to receive tax-deductible contributions;[3] also, churches are not required to file annual information returns with the IRS.[4] In addition, as described below, IRS audits of churches are subject to special restrictions.

A religious organization that constitutes a church is classified as a public charity rather than as a private foundation, whether or not the organization is publicly supported.[5] Accordingly, donors to churches (like donors to other public charities) generally receive more favorable treatment of their contributions than donors to certain other types of charitable organizations.

Definitions

The terms "religious" and "church" are not defined in either the Internal Revenue Code or Treasury regulations. For administrative purposes, the IRS has formulated certain criteria to which it refers in ascertaining whether a religious organization constitutes a

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[2] Rev. Rul. 68-563, 1968-2 C.B. 212, amplified in Rev. Rul. 78-385, 1978-2 C.B. 174. Any income received from the presentation of commercial programs, including income from the sale of advertising for air time, is subject to the unrelated business income tax under secs. 511-513 (Rev. Rul. 78-385).

[3] Sec 508(c)(1)(A). This exception to the exemption application requirement also applies to conventions or associations of churches and to integrated auxiliaries of churches.

[4] Sec. 6033(a)(2)(A)(i). This exception to the information return requirement also applies to conventions or associations of churches, integrated auxiliaries of churches, and the exclusively religious activities of any religious order.

[5] Secs. 509(a)(1), 170(b)(1)(A)(i). This rule also applies to conventions or associations of churches.

church. The IRS position is that, in order to qualify as a church for Federal income tax purposes, an organization must satisfy at least some of the following criteria: (1) a distinct legal existence; (2) a recognized creed and form of worship; (3) a definite and distinct ecclesiastical government; (4) a formal code of doctrine or discipline; (5) a distinct religious history; (6) a membership not associated with any other church or denomination; (7) a complete organization of ordained ministers ministering to their congregations and selected after completing prescribed courses of study; (8) a literature of its own; (9) established places of worship; (10) regular congregations; (11) regular religious services; (12) schools for the religious instruction of the young; (13) schools for the preparation of its ministers; and (14) any other facts and circumstances that may bear upon the organization's claim to church status.[6]

The U.S. Tax Court has stated that these criteria developed by the IRS for administrative purposes are useful guidelines, but not controlling rules, in determining whether an otherwise tax-exempt religious organization qualifies for the narrower category of a church. In making this determination, the Tax Court has taken into account such factors as whether such an organization provides regular religious services, conducted by an organized ministry, for established congregations at established places of worship; whether the organization has a distinct religious history and beliefs that set it apart from other recognized religions; and whether the organization has more than merely incidental associational aspects.[7]

For example, in a recent case,[8] the Tax Court held that an organization (the Foundation of Human Understanding) that spread the teachings of its founder through radio broadcasts, books, pamphlets, and a magazine and also regularly conducted religious services constituted a church for Federal income tax purposes. The broadcasting and publishing activities accounted for a large percentage of the organization's total expenditures and receipts. Noting that "the call to evangelize or otherwise spread one's religious beliefs is, undeniably, an integral part of many faiths," the Court also found that the organization's substantial broadcasting and publishing activities did not "overshadow the other indications" that it constituted a church. The Court emphasized that the organization, which employed nine ordained ministers, regularly conducted religious services several times a week at two locations where its followers congregated. Finding that the organization's associational aspects were "much more than incidental" and that other criteria listed by the IRS had been met, the Court concluded that the organization constituted a church for Federal income tax purposes.

Courts have uniformly rejected claims of tax-exempt status for, or deductibility of contributions to, "mail-order ministries" and similar situations where individuals attempt to claim "church" status as part of tax-avoidance schemes.[9] Mail-order ministries gen-

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[6] *See* IRS Manual 7(10)69 Exempt Organizations Examination Guidelines Handbook, sec. 321.3 (April 5, 1982).

[7] *See, e.g., Foundation of Human Understanding* v. *Comm'r*, 88 T.C. No. 75 (1987) (reviewed by the Court); *Pusch* v. *Comm'r*, 39 T.C.M. 838, *aff'd.* 628 F.2d 1353 (5th Cir. 1980).

[8] *Foundation of Human Understanding* v. *Comm'r*, *supra*, note 7.

[9] *See, e.g., Miedaner* v. *Comm'r*, 81 T.C. 272, 282 (1983); *Basic Bible Church* v. *Comm'r*, 74 T.C. 846 (1980); Rev. Rul. 81-94, 1981-1 C.B. 330; Rev. Rul. 78-232, 1978-1 C.B. 69.

erally are situations where a secularly employed individual places all of his or her wages in an organization created through the use of a mail-order charter under which the organization pays for the individual's living expenses.

B. Prohibition of Inurement to Private Interests

In general

An organization cannot qualify for tax-exempt status as a church, or other religious or charitable organization, and is not eligible to receive tax-deductible contributions, if any part of its net earnings inures to the benefit of a private individual (secs. 501(c)(3), 170). This prohibition is intended to ensure that the organization fulfill the rationale for such tax benefits by devoting itself exclusively to the public good, and to prevent the organization from conferring financial benefits (other than reasonable compensation) on persons having a personal or private interest in its activities.[10]

In applying the prohibition on inurement, court decisions have closely scrutinized churches or other entities that are controlled by one person because of the potential for abuse in such organizations, and have stated that such a closely controlled organization must make full disclosure to the court of all relevant facts bearing on its exemption application or claim of exempt status.[11]

Forms of inurement

Private inurement can take a variety of forms, including the payment of dividends or excessive compensation to an individual with an interest in the organization.[12] In determining whether an employee or other recipient of payments from an exempt organization has received excessive compensation, all benefits received in exchange for services—such as bonuses, deferred compensation, below-interest or unsecured loans, payments of personal expenses, the personal use of cars, airplanes, or residences, and other benefits—are taken into account, as well as salaries.

Reasonable compensation generally is defined as the amount that would ordinarily be paid for like services by like organizations under like circumstances (*see* Treas. Reg. sec. 1.162-7(b)(3)). Under this standard, reasonableness generally is determined by reference to comparable employment agreements. Relevant factors cited in assessing comparability have included the date on which the service contract was made, the size of the organization, the nature of the services provided, and the individual's qualifications, experience, and familiarity with the organization.

Private inurement can occur through means other than the payment of dividends or excessive compensation. In a recent decision,[13] the Ninth Circuit Court of Appeals upheld revocation of the

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[10] *See* Treas. Reg. secs. 1.501(c)(3)-1(c)(2), 1.501(a)-1(c), 1.501(c)(3)-1(d)(1)(ii).

[11] *See, e.g., Church of Scientology of California* v. *Comm'r*, 1987-2 U.S.T.C. par. 9446 (9th Cir. 1987), *aff'g* 83 T.C. 381 (1984); *Bubbling Well Church of Universal Love* v. *Comm'r*, 74 T.C. 531, 535 (1980), *aff'd*, 670 F.2d 104 (1981).

[12] *See, e.g., Founding Church of Scientology* v. *U.S.*, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970); *Unitary Mission Church* v. *Comm'r*, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981); *Easter House* v. *U.S.*, — F.2d — (Ct. Cl. 1987); *cf. Presbyterian and Reformed Publishing Co.* v. *Comm'r*, 743 F.2d 148 (3d Cir. 1984) (salaries held reasonable).

[13] *Church of Scientology of California* v. *Comm'r*, 1987-2 U.S.T.C. par. 9446 (9th Cir. 1987).

exemption of the Church of Scientology (California) on a finding of inurement, through means other than salary payments, of net earnings to the benefit of L. Ron Hubbard, founder of the Church, and others. The facts cited by the Court included (1) the Church's aggressive marketing of Hubbard's works and its practice of copyrighting publications authored by Church employees in his name, in conjunction with payments of substantial royalties; (2) Hubbard's "unfettered control over millions of dollars in Church assets," in the absence of testimony and documentation to trace the source and use of these funds; and (3) payment of 10 percent of the gross income of Scientology congregations, franchises, and organizations to Hubbard. The exact dollar amount of these latter payments was deemed irrelevant, the Court held, inasmuch as the statute provides that "no part" of an exempt organization's net earnings may inure to a private individual.

Nonabusive compensation arrangements

In some circumstances, payments based on a percentage of net profits have been held not to violate the prohibition on inurement. For instance, the IRS has permitted tax-exempt organizations to adopt percentage compensation arrangements if the following five circumstances are present:

(1) the arrangement derives from a completely arm's-length contractual relationship, with the service-provider having no participation in the management or control of the organization;

(2) the contingent payments serve a real and discernible business purpose independent of any purpose to operate the organization for the benefit of the service-provider;

(3) the amount of the compensation is not dependent principally on revenue of the exempt organization but rather on the accomplishment of the objectives of the compensatory contract;

(4) review of the actual operating results reveals no evidence of abuse or unwarranted benefits; and

(5) there is a ceiling or reasonable maximum so as to avoid the possibility of a windfall benefit to the service-provider based on factors having no direct relationship to the level of service provided.[14]

In addition, the Internal Revenue Service has permitted a tax-exempt organization to offer its employees a qualified profit-sharing plan, so long as the amount contributed to the plan constituted reasonable compensation and the plan met other requirements of Federal law.[15] In doing so, the IRS acknowledged that such plans further an exempt purpose by increasing employee productivity.

Parsonage allowance

In general

The Code provides an exclusion from gross income for (1) the rental value of a home furnished to a minister as part of the minister's compensation, or (2) a rental allowance paid to a minister as part of compensation to the extent used to rent or provide a home (sec. 107). The rental allowance exclusion applies to amounts of

[14] G.C.M. 38905 (June 11, 1982).
[15] G.C.M 38283 (February 15, 1980).

compensation used during the year to rent or otherwise provide a dwelling, including directly related expenses. Thus, the exclusion applies to the value of a dwelling furnished to the minister, together with furniture, fixtures, and appliances; rent or mortgage payments for a residence; costs of improvements or remodeling; and expenditures for utilities, insurance, and maintenance and repair.[16]

Under the present law, there is no limit on the amount of the exclusion for a parsonage allowance, provided that the amount does not exceed reasonable compensation for the minister's services, and any rental allowance is, in fact, used by the minister to rent or otherwise provide a home.[17]

Deductibility of interest and tax

In 1983, the IRS ruled that a minister could not claim deductions for mortgage interest and real estate taxes on a residence to the extent such expenditures were allocable to tax-free housing allowances received by the minister. The IRS took the position that where a taxpayer incurred expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265 (disallowing deductions for expenses allocable to tax-exempt income).

The Tax Reform Act of 1986 overruled the IRS position and provided that section 265 shall not disallow otherwise allowable deductions for interest paid on a mortgage on, or real property taxes paid on, the home of a minister, on account of an excludable parsonage allowance. Accordingly, a minister may exclude the amount of compensation received as a housing allowance, and (if the minister itemizes deductions) may offset other income with deductions for expenditures for residential mortgage interest and real estate taxes.

C. Restrictions on Political and Lobbying Activities

In general

Charitable organizations for which deductions are allowed for Federal income tax purposes, including churches, cannot engage in any political activity and cannot engage in more than an insignificant amount of lobbying activity (secs. 501(c)(3) and 170(c)(2)).[18] Thus, if a church intervenes in a political campaign or engages in substantial lobbying, including through the use of broadcast facilities, then its tax-exempt status may be jeopardized.[19]

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[16] *See* Treas. Reg. sec. 1.107-1(c); *Jimmy L. Swaggart* v. *Comm'r*, 48 T.C.M. 759 (1984).

[17] Treas. Reg. sec. 1.107-1(a); Rev. Rul. 78-448, 1978-2 C.B. 105.

[18] In the case of exempt organizations for which charitable deductions for contributions are not allowed for Federal income tax purposes, the rules are much less restrictive. In some cases, both lobbying and political activities are allowed so long as those activities are not the principal activity of the organization. For a discussion of the rules governing political and lobbying activities of different types of exempt organizations, see Joint Committee on Taxation, *Lobbying and Political Activities of Tax-Exempt Organizations* (JCS-5-87), March 11, 1987.

[19] The question of whether or not the tax-exempt status of a church can be revoked because of its participation in political or lobbying activities raises a number of constitutional issues. For cases involving these issues, see *Christian Echoes National Ministry, Inc.* v. *United States*, 470 F.2d 849 (10th Cir. 1972) (religious organization which broadcast radio and television shows

Continued

Political activity

Because section 501(c)(3) organizations are subject to a ban on political activity, the principal issue presented by this rule is, simply, the definition of "political" activity. In general, prohibited political activity involves the participation or intervention, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.[20] The office involved can be national, state, or local; and it is not required that the election be contested or involve the participation of political parties.[21]

The determination of what constitutes intervention in a political campaign requires weighing all relevant facts and circumstances.[22] Section 501(c)(3) specifically mentions "the publishing or distributing of statements" that support or oppose a candidate as examples of political intervention. Other clear examples would include making or soliciting campaign contributions, providing publicity or volunteer assistance, and paying expenses of a political campaign. In many cases, the critical issue in determining whether an activity constitutes intervention in a political campaign is whether it reflects or advances a preference between competing candidates.[23]

When members of an organization are involved in political activities, it is necessary to determine whether such activities are attributable to the organization, or instead are undertaken independently by the individuals in their private capacities. In general, principles of agency are relevent to this determination. For example, acts undertaken by individuals under actual or purported authority to act for the organization, and acts planned or ratified by the organization, are considered activities of the organization.[24] Where an exempt organization uses a business subsidiary as a "guise" for carrying out particular activities without restriction, the subsidiary's activities are attributed to the parent.[25]

Lobbying activity

In contrast to the absolute ban on political activity, a church or other organization seeking exemption under section 501(c)(3) is permitted to engage in some lobbying activity provided that the activity is not "substantial." Thus, it is necessary for purposes of section 501(c)(3) not only to define "lobbying" activity, but also to determine the meaning of the term "substantial."

In general, a section 501(c)(3) organization is engaged in lobbying activity if it advocates the adoption or rejection of legislation. For

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found not to be tax-exempt on ground that it engaged in political and lobbying activities); *In re United States Catholic Conference and National Conference of Catholic Bishops*, 824 F.2d 156 (2d Cir. 1987) (holding that trial court had colorable basis for exercise of subject matter jurisdiction over lawsuit alleging that the Catholic Church has engaged in political activity violative of section 501(c)(3) by opposing candidates who support the allowability of abortions). Such constitutional issues are beyond the scope of this pamphlet.

[20] Sec. 501(c)(3); Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii).

[21] Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii); Rev. Rul. 67-71, 1967-1 C.B. 125.

[22] *See, e.g.*, Rev. Rul. 78-248; 1978-1 C.B. 154.

[23] Endorsing a candidate for public office constitutes intervention in a political campaign. *See, e.g.*, G.C.M. 39941 (November 7, 1985). It also has been held that opposing a candidate likewise constitutes intervention, even if the organization does not formally endorse the candidate's opponent. *See, e.g., Christian Echoes National Ministry, supra. See also* section 201(a) of H.R. 2942, introduced on July 15, 1987, which would codify that position.

[24] *See* G.C.M. 34631 (October 4, 1971).

[25] *See* G.C.M. 33912 (August 15, 1968).

this purpose, the term "legislation" includes action by Congress or any State or local legislative body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.[26] Lobbying includes such activities as (1) directly contacting members of a legislative body (or their staffs) to propose, support, or oppose legislation, (2) grass roots lobbying (urging the public to contact legislators or legislative staffs to propose, support, or oppose legislation), and (3) more generally, advocating the adoption or rejection of legislation.[27]

If it is determined that an organization otherwise qualifying under section 501(c)(3) has engaged in lobbying, it is then necessary to determine whether the lobbying activity was substantial. The Internal Revenue Code does not explain the meaning, in this context, of the term "substantial"; and there is no precise mechanical rule for determining the substantiality of an organization's lobbying activities in relation to its other activities.[28] In particular, an arithmetical percentage test (e.g., looking at the percentage of the budget, or of employees' time, spent on lobbying), while relevant, has been held not determinative.[29] The reason for not looking solely at the percentage of time or money spent by an organization on lobbying is that such an approach might give an incomplete picture to the extent that it does not reflect any volunteer time and publicity devoted to the lobbying activities by an organization, and the continuous or intermittent nature of the organization's involvement in such activities.[30]

D. Unrelated Business Income Tax

Elements of an unrelated trade or business

Under present law, tax-exempt organizations are subject to tax on their unrelated business income. Subject to specified exceptions and modifications, income derived from an activity of an otherwise tax-exempt organization is subject to the unrelated business income

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[26] Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(ii). Attribution principles, similar to those applied with political activities, are used to determine if the lobbying activities of members of an organization are attributable to the organization itself.

[27] There are a number of circumstances, however, in which commenting on proposed legislation is not treated as lobbying. These include (1) making available the results of nonpartisan analysis, provided the organization takes no position, and (2) providing technical advice or assistance in response to a formal request by a governmental body. *See* Rev. Rul. 64-195, 1964-2 C.B. 138; Rev. Rul. 70-449, 1970-2 C.B. 111. In addition, lobbying may not include certain activities that are directly in the self-interest of the exempt organization itself, such as commenting on legislation that might affect any organization's existence, powers and duties, or tax-exempt status. Moreover, lobbying may not include soliciting government funds for the organization's programs. *See Slee v. Comm'r* 42 F.2d 184 (2d Cir. 1930).

[28] Under section 501(h), enacted by Congress in 1976, certain organizations seeking to qualify under section 501(c)(3) can elect to have the amount of lobbying in which they may engage measured under a precise arithmetical test (which sets separate limits on direct lobbying and grass roots lobbying) rather than just the general "substantiality" standard. However, certain types of organizations, including churches, cannot elect the application of section 501(h). Churches were made ineligible for section 501(h) election at their own request, after expressing concerns that both prior law and the rules under section 501(h) might infringe upon their constitutional rights under the First Amendment. *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* at p. 415.

[29] *See Seasongood v. Comm'r*, 227 F.2d 907 (6th Cir. 1955); (where less than 5 percent of an organization's time and effort were spent on lobbying activities, such activities were not substantial in relation to the organization's other activities); *Haswell v. United States*, 500 F.2d 1133 (Ct. Cl. 1974), *cert. denied*, 419 U.S. 1107 (1975) (the fact that an organization spent between 16.6 percent and 20.5 percent of its budget on lobbying provided a strong indication of substantiality).

[30] G.C.M. 36148 (January 28, 1975).

tax (UBIT) if (1) the income is derived from a trade or business, (2) the trade or business is regularly carried on by the organization, and (3) the conduct of the trade or business is not substantially related (aside from the organization's need for revenues or the use it makes of such revenues) to the organization's performance of its tax-exempt functions (secs. 512(a), 513(a); Treas. Reg. sec. 1.513-1(a)).

Definition of trade or business

In general, any activity that is carried on for the production of income from the sale of goods or the performance of services constitutes a trade or business for purposes of the UBIT. Such an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or other endeavors that may be related to the organization's exempt purposes.[31] For example, advertising activities do not lose their identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.[32] If an activity carried on for profit constitutes an unrelated trade or business, no part of the activity will be disregarded merely because it does not result in profit.[33]

Regularly carried on test

Even if an exempt organization conducts an unrelated trade or business, the income therefrom is not subject to the UBIT unless the activity is "regularly carried on" by the organization (sec. 512(a)). This test looks to the frequency and continuity of the income-producing activities, and the manner in which the exempt organization conducts the activities as compared with the manner in which commercial activities are normally pursued by taxable businesses. Specific business activities of an exempt organization ordinarily are deemed to be regularly carried on "if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[34]

Substantially related test

Even if a tax-exempt organization regularly carries on a trade or business, the income from that activity is subject to the UBIT only if the activity is unrelated to the basis for the organization's tax-exempt status—i.e., only if the activity is not substantially related (other than through the production of funds) to the purposes for which the organization's exemption is granted.[35]

The Treasury regulations provide that in order to meet the "substantially related" test, the business activity must "contribute importantly" to the accomplishment of the organization's exempt purposes. Whether this test is met depends in each case on the facts and circumstances involved.[36] In appropriate circumstances, com-

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[31] Sec. 513(c); Treas. Reg. sec. 1.513-1(b).
[32] Treas. Reg. 1.513-1(b).
[33] Sec. 513(c); Treas. Reg. sec. 1.513-1(b).
[34] Treas. Reg. sec. 1.513-1(c).
[35] Sec. 513(a); Treas. Reg. sec. 1.513-1(d).
[36] Treas. Reg. sec. 1.513-1(d).

mercial endeavors such as the operation of a winery or a farm have been held not substantially related to the exempt purpose of religious organizations.[37]

In determining whether business activities contribute importantly to accomplishing exempt purposes, the size and extent of the activities are weighed against the nature and extent of the exempt function which they are said to serve. Thus, if an organization derives income from activities that are in part related to the performance of its exempt functions, but that are conducted on a larger scale than reasonably necessary to perform those functions, the income attributable to that portion of the activities exceeding the exempt function needs constitutes unrelated business income.[38]

Excluded activities and income

Certain activities are exempt from the UBIT. For instance, the tax does not apply to income earned by a tax-exempt charity from a trade or business carried on by the organization primarily for the convenience of its members or employees (sec. 513(a)(2)). And it does not apply to income from an activity in which substantially all the work is performed without compensation (sec. 513(a)(1)). This latter exclusion has been held to exclude from the UBIT farming by the brothers of a Catholic monastic order when the brothers received no compensation for their labor but only support allowances unrelated to their services.[39]

In addition, certain types of income (and associated deductions) are excluded from the UBIT. The UBIT generally does not apply to dividends, interest, royalties (including overriding royalties), annuities, certain rents, gains on the disposition of property (other than inventory property), gains on the lapse or termination of securities options written by the organization in connection with its investment activities, and amounts received in connection with certain securities loans.

The exclusions from income generally do not apply to the extent the income is derived from debt-financed property, the use of which is not substantially related to the organization's exempt purposes.[40] A percentage of the income from property reflecting the degree to which such property is debt financed is included in unrelated business taxable income.

E. Transfers to Charities in Exchange for Goods or Services

Under present law, payments which qualify as a "contribution or gift" within the meaning of section 170(c) are deductible by the donor.[41] Although the Internal Revenue Code does not define the

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[37] *See St. Joseph Farms* v. *Comm'r*, 85 T.C. 9 (1985) (operation of farm); *De La Salle Institute* v. *United States*, 195 F. Supp. 891 (1961) (operation of winery).

[38] Treas. Reg. sec. 1.513-1(d).

[39] *See St. Joseph Farms, supra* n. 37.

[40] Other exceptions to the definition of debt-financed property for purposes of section 514 generally resemble exceptions to the scope of unrelated business taxable income applying for purposes of sections 511-513. See section 514(b). For further description of the unrelated business income tax rules, see Joint Committee on Taxation, *Overview of the Unrelated Business Income Tax on Exempt Organizations* (JCS-16-87), June 20, 1987.

[41] The taxpayer generally has the burden of proving that a particular payment is a "contribution or gift." *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); *Welch* v. *Helvering*, 290 U.S. 111 (1933).

phrase "contribution or gift," in general, it is construed as requiring a voluntary transfer of property to a qualifying organization, made without consideration.[42] Thus, if a taxpayer makes a payment to a church or other religious organization and in return receives, or expects to receive, an economic benefit (i.e., a *quid pro quo*), then the payment does not constitute a deductible charitable contribution.[43]

Examples of payments to churches or religious organizations that do not qualify as deductible contributions include: (1) payments to a church for use of facilities for a wedding,[44] (2) tuition payments to parochial schools,[45] (3) payments to a religious home to care for a relative of the payor,[46] and (4) payments for the purchase of raffle tickets.[47]

If the transferor receives, or can reasonably expect to receive, property or services in return for making a payment to a church or religious organization, then a presumption arises that the payment is not a deductible contribution.[48] However, a portion of the total payment may still be deductible if the taxpayer establishes that this portion of the payment exceeded the value of the benefits received.[49] When the benefit received is in the form of goods or services generally priced in a competitive market, the value of the economic benefit conferred can be measured by reference to the competitive price.[50] If the benefit received is not normally sold in a competitive market, only that portion of the payment which exceeds a reasonable estimate of the fair market value of the benefit may be designated as a charitable contribution.

F. Restrictions on Church Tax Inquiries and Examinations

In general

Because of the sensitive relationship between church and state, Congress has adopted specific statutory rules governing church inquiries and examinations. These rules are intended to protect the privacy of churches while permitting reasonable IRS examinations.

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[42] *See DeJong* v. *Comm'r*, 36 T.C. 896 (1961), *affd.* 309 F.2d 373 (9th Cir. 1962); Rev. Rul. 76-185, 1976-1 C.B. 60.

[43] *See, e.g., Miller* v. *Comm'r*, No. 86-2090 (4th Cir. September 18, 1987) (Church of Scientology member's payments for religious counseling were not deductible gifts but were payments for services); *Graham* v. *Comm'r*, 83 T.C. 575 (1984) (same). *But see Staples* v. *Comm'r*, 821 F.2d 1324 (8th Cir. 1987) (payments for religious counseling held deductible on ground that participation in religious practices is not a recognizable economic benefit under sec. 170).

[44] *See, e.g., Summers* v. *Comm'r*, para. 74,162 P-H Memo T.C.

[45] *See, e.g., Fausner* v. *Comm'r*, 55 T.C. 620 (1971); *Winters* v. *Comm'r*, 468 F.2d 778 (2d Cir. 1972).

[46] *See, e.g.*, Rev. Rul. 58-303, 1958-1 C.B. 61. But see *Wardwell* v. *Comm'r*, 301 F.2d 632 (8th Cir. 1962).

[47] *See, e.g., Goldman* v. *Comm'r*, 388 F.2d 476 (6th Cir. 1967). In some cases where *de minimis* benefits are conferred which are clearly incidental to the benefits that inure to the organization as a whole or members of the general public, a deduction may be available. See, *e.g., Miller* v. *Comm'r*, *supra*; Rev. Rul. 70-47, 1970-1 C.B. 49 (pew rents and periodic dues of church are deductible).

[48] Rev. Rul. 67-246, 1967-2 C.B. 104.

[49] Rev. Rul. 76-185, 1976-1 C.B. 60 (payments made to finance restoration of historic mansion, in exchange for right to live in mansion for 15 years not deductible unless in excess of value received.)

[50] *See United States* v. *American Bar Endowment*, 106 S. Ct. 2426 (1986) (payments for insurance did not exceed market value); *Werbianskyj* v. *Comm'r*, 34 T.C.M. 467 (1975) (products brought from Girl Scouts not deductible; no showing that price paid was substantially greater than products' value).

Initiation and first notice

The IRS may begih a church tax inquiry or examination into whether the organization qualifies for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities only if the IRS regional commissioner (or a higher IRS or Treasury official) reasonably believes, on the basis of facts and circumstances recorded in writing, that the organization may be engaged in such business or activities.

Upon beginning a church tax inquiry, the appropriate regional commissioner is required to provide written notice to the church. This notice must include an explanation of the concerns that gave rise to the inquiry and the general subject matter of the inquiry, specific enough to allow the church to understand the particular church activities or behavior at issue.

Second notice and subsequent proceedings

The IRS may examine church records or religious activities only if, at least 15 days before the examination, the IRS provides a tax examination notice in addition to the general tax inquiry notice previously provided.

As part of this notice, the church must be offered one opportunity to meet with an IRS official to discuss the concerns that gave rise to the inquiry and the general subject matter of the inquiry. The purpose of the conference is to inform the church, in general terms, of the stages of the church tax inquiry and examination procedures and to discuss the relevant issues that may arise as part of the inquiry, in an effort to resolve the issues of tax exemption or tax liability without examining church records or activities.

Generally, the IRS must complete any church tax inquiry and examination, and make a final determination, no later than two years after the date on which the notice of examination is mailed to the church.

Approval of determinations and requested examinations

The appropriate IRS regional counsel must approve (1) any determination that an organization does not have tax-exempt status as a church (sec. 501(a)), (2) any determination that such an organization is not eligible to receive tax-deductible contributions (sec. 170(c)), or (3) the issuance of a notice of deficiency to a church following a church tax examination (or, in cases where deficiency procedures are inapplicable, the assessment of any underpayment of tax by the church). Moreover, the IRS Assistant Commissioner (Employee Plans/Exempt Organizations) in general must approve any second tax inquiry or examination of a church within five years of any earlier inquiry or examination involving the same or similar issues.

Scope of inquiry and examination procedures

The church tax inquiry and examination procedures do not apply to inquiries or examinations that relate primarily to the tax status

or liability of persons other than the church. Thus, not subject to the special church rules are inquiries or examinations regarding (1) the inurement of church funds to a particular individual or to another organization, which inurement may result in the denial of all or part of such individual's or organization's deduction for contributions to the church, (2) the assignment of income or services or excessive contributions to a church, and (3) a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church.

In addition, the special church tax procedures do not apply to any case involving a knowing failure to file a return or a willful attempt to defeat or evade income or employment taxes, or to criminal investigations.

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